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## When Local Risks Become Global Risks, and How We Can Minimize Them

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Climate change. Middle East instability. International terrorism. Oil price shocks. Weapons of mass destruction. Extreme weather events. The world is fast becoming a riskier place, and the days of wait-and-see are no longer an option, says the World Economic Forum's recently released [Global Risks 2007 report](http://www.weforum.org/pdf/CSI/Global_Risks_2007.pdf) ([http://www.weforum.org/pdf/CSI/Global\\_Risks\\_2007.pdf](http://www.weforum.org/pdf/CSI/Global_Risks_2007.pdf)).

The report, published in cooperation with Wharton's [Risk Management and Decision Processes Center](http://grace.wharton.upenn.edu/risk/) (<http://grace.wharton.upenn.edu/risk/>) and presented to world leaders at Davos in January, identifies 23 core risks - most of which, the report argues, have worsened over the last year, despite growing awareness of their consequences. It also underscores a growing disconnect between the power of these risks to disrupt the world and our ability to mitigate them.

Wharton professor and Risk Center co-director [Howard Kunreuther](http://www.wharton.upenn.edu/faculty/kunreuth.html) (<http://www.wharton.upenn.edu/faculty/kunreuth.html>), along with several other Wharton faculty members, played a key role in contributing to the report's methodology. Kunreuther and management professor [Stephen Kobrin](http://www.wharton.upenn.edu/faculty/kobrins.html) (<http://www.wharton.upenn.edu/faculty/kobrins.html>), both of whom attended the World Economic Forum in Davos in January, have also been part of the WEF's Global Risk Network since its inception three years ago.

"Many organizations and governments are still basing their decisions and actions on risk and crisis management tools developed 20 years ago," says Erwann Michel-Kerjan, managing director of Wharton's Risk Management and Decision Processes Center, who is also a contributor to the report. "But the hallmarks of this new century include more and more unthinkable events, previously unseen contexts, and pressure for private companies and government authorities to react extremely quickly, even when they cannot predict the impact their actions will have. The bottom line is this: If your company still applies the old paradigm to this new era, it's spending its resources in the wrong direction."

With this in mind, the report recommends two proactive measures its authors believe will help businesses and governments prepare for the new global risk landscape. First, it proposes the idea of a Country Risk Officer -- similar to the corporate world's Chief Risk Officer -- to serve in each country as a focal point for managing risk across disparate interests, to set national priorities involving various risks and to guide governments toward forward-thinking actions.

The report also argues for creating what it calls "coalitions of the willing" -- flexible groupings of governments and corporations that would work together toward minimizing different global risks. "The advantage of such a system," says Kunreuther, "is its ability to cut through the bureaucratic quagmire that often accompanies international risk management efforts."

### The Anthrax Threat

How would such a system work? To illustrate, Michel-Kerjan points to a collaboration he and colleague Patrick Lagadec from Ecole Polytechnique in Paris led during the aftermath of the 2001 Anthrax crisis. The two created and helped launch an international plan of action to manage future threats -- a process that began with just a few postal operators in Europe but quickly spread as executives stepped in from postal services in the United States and more than 20 other countries, as well as from international trade associations.

The initiative had quantifiable results, such as the creation of a global web-based alert and information-sharing platform detailing the solutions each country had implemented. It also "reinforced trust, a crucial element when collectively trying to face the unknown," Michel-Kerjan says. On January 15, 2003, the day it became fully operational, the system passed a critical test when the U.S. Postal Service advised PostEurop of a potential anthrax contamination near Washington, D.C., and postal services across Europe were given accurate and timely information. "Global risks require a global reaction capacity and a critical mass of organizations willing to be leaders in developing a new model for the new era we have entered," says Michel-Kerjan. "Putting together coalitions of the willing worldwide would move us in this direction, and the anthrax action framework could easily be applied to other industries."

In preparing the WEF report and addressing the likelihood of various global risks, its authors calculated risk where sufficient data existed; where it did not, experts offered opinions, evaluating each of the risk categories by severity within a 10-year time frame in terms of economic losses and number of deaths. In addition, the report's contributors created a qualitative global risk "barometer," a forward-looking measure that assesses whether a particular risk is

likely to increase within the next 10 years. Tropical storms, for instance, declined in 2006 over 2005, but expert consensus was clear that the risk trend is moving upwards. The 23 key risks experts identified are grouped in five categories: economic, environmental, geopolitical, societal and technological.

The report also makes specific recommendations for four of today's most visible global risks -- oil price shock/energy supply interruptions, international terrorism, pandemics and climate change. The recommendations include the following:

#### Climate Change:

- "Urgently" begin work on a Kyoto agreement successor that includes the U.S. and major developing countries such as China.
- Raise awareness in the developing world of the effects of climate change.
- Expand market mechanisms -- such as carbon emissions credit trading -- that encourage innovation, reward efficiency and facilitate the development of insurance and other financial tools to manage the risks that come with emissions reductions projects.

#### International Terrorism:

- Renew terrorism insurance schemes scheduled to sunset in 2007; improve framework for public/private arrangements in other countries.
- Improve tracking of financial flows to cut off funding of dispersed terrorist cells.
- Link energy security with considerations on climate change.

#### Oil Price Shock:

- Eliminate remaining energy-price subsidies. This is particularly necessary to encourage energy efficiency in emerging markets and hydro-carbon-rich nations.
- Stockpile oil in Strategic Petroleum Reserves but release supplies unpredictably to undercut speculative psychology in the markets.

#### Pandemic Threats:

- Strengthen collaborative preparation activities such as simulations. Strengthen decision-modeling exercises locally and nationally.
- Develop domestic plans for distributing and administering vaccines and other medicines.
- Develop an equitable and agreed-upon basis for international distribution of vaccines between manufacturing and consuming countries.

But for all of the report's urgent recommendations, the biggest challenge in implementing them may still be mobilizing governments and businesses to act -- and to act quickly. "All of us are myopic. We want a sufficient return in the short run to justify the upfront costs of protection," Kunreuther says. "We often decide not to invest in risk reducing measures because we fail to consider that the expected benefits from these options are likely to extend over many years. Individuals and corporations often justify expenditures to reduce or mitigate risks by expecting to recoup their investment within a two- or three-year period. There is also a tendency to procrastinate and say, 'Let's wait until tomorrow to make a decision on whether to incur these costs.'"

### Security as a Marketing Tool

According to Michel-Kerjan, consumers have an important role to play in driving such change. "Think of buying a new car," he says. "About 20 or 30 years ago, most customers did not focus on car safety, nor did car manufacturers use safety as a marketing argument. But today you see ads everywhere highlighting the safety elements of the vehicle along with five-star ratings and crash test results. Safety has become part of the intrinsic value of a car, and this is reflected in its price."

Ten years from now, Michel-Kerjan believes, security will similarly become a marketing tool. "This is even more likely to be true if the rhythm and scale of catastrophes continue to accelerate so it becomes more and more difficult to see these as low-probability, extreme events anymore. Are we ready to pay more for a more secure product or service in the same way that you do for a safer car? Homes and offices could be built to be more resistant to natural disasters, and information systems could be designed with more security protections, just to name a few possibilities. I predict more companies will see security as a competitive advantage and integrate it into their business strategy."


With this in mind, the Global Risks report outlines five "pathways" to mitigation. In order to proactively mitigate risk, the report says, companies must improve insight, enhance information flow, refocus incentives, improve investment and implement through institutions. "Some risks can effectively be mitigated with relatively few resources by changing individual mindsets and altering behaviors," the report says. "Others require strong institutional processes and actions."


The report -- done in collaboration with Citigroup, Marsh & McLennan Companies and Swiss Re -- acknowledges that moving from "the assessment of individual global risks to the mitigation of global risks under conditions of uncertainty, interdependency and competing interests is far from simple. Mitigation involves a constant balance between action and reaction, between preventing a risk from occurring and dealing with its consequences when it does, between acting rashly and acting too late ... .Global risks cannot, for the most part, be mitigated out of existence. [But] inaction ... is not an option -- either for businesses or government." In the coming months, the Global Risk Network plans to "energetically" communicate this reality to build worldwide support -- a necessary first step in implementing its many recommendations, Kunreuther says.

Kunreuther, who in the five years since the September 11, 2001, attacks has worked to convince individuals and firms about the necessity of investing in cost-effective protective measures, argues most fervently about the importance of understanding the interconnectedness and interdependencies that come with global risks.

"Why does interdependency matter for security? Why should we take protective measures against risks if others have not? The fact is that if there is a hurricane, it could cause problems with oil prices, with a whole series of supply interruptions that could have repercussions on a much broader level than just the region affected by the storm," Kunreuther says. More recently, the Global Risks report notes, "the connections between two of the major issues for public policy and private enterprise -- energy security and climate change -- have reinforced the sense that global risks share a common lineage."

Risks "are no longer local, but global," adds Michel-Kerjan. "And one major feature of global risks is that no one single organization or country can face them alone. The world is now so interdependent that actions taken today 5,000 miles away might affect you tomorrow. Conventional wisdom holds that one country or one organization can have the capacity and expertise to manage future catastrophic risks alone. In an increasingly global interdependent world, they will have neither. This new era calls for a new model."

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